

Market commentary

October 2019

"Learn how to see. Realize that everything connects to everything else"

Leonardo da Vinci

Overview

In 2019, we are witnessing conditions in global bond markets, never seen before in the history of finance. Jerome Powell, the US Federal Reserve Chairman, cut interest rates in the US for the first time in a decade and followed up with further cuts over the summer, signalling his readiness to provide more support for slowing global economic growth as US trade tensions with China intensified. Professional investors, who want to invest in a fixed and secure income stream for their investment portfolios, purchase bonds issued by governments but this year, the interest rates (known as bond yields) have been tumbling to historical low levels. In August, it became impossible to invest in a US Treasury Bond (essentially lending to the US government) over any time period above 2% for the first time in history. For a brief period in August, all German bonds were offering negative interest rates to investors. Swiss, Swedish and Japanese bonds were also offering negative rates across all time periods. In Switzerland, if you were to invest in a ten-year government bond, you would be locking into a -1.2% per annum loss over ten years. A guaranteed formula for losing 12% of your capital. For the first time ever, the third largest bank in Denmark offered mortgages at -0.5% and the United Bank of Switzerland (UBS) was charging a fee to the super-rich to hold cash deposits. \$16.4 trillion worth of bonds globally are now offering negative yields, approximately a third of all government bonds in the world. These are extraordinary numbers by any measure.

Low interest rates are not good for bank profitability, which has struggled since the financial crisis and the total market value of the 26 largest banks in Europe is now below the total value of Facebook, the social media company, as a consequence. It is not an understatement to suggest that the asset class is suffering an existential crisis as investment managers can find few reasons to lock into guaranteed losses. Balanced investment portfolios which have traditionally mixed bonds with equities to temper risk and represent the bulk of most investment portfolios globally are now being restructured accordingly but the early evidence suggests, it is towards a riskier mix of equities as a source of enduring income, derived from company dividends rather than bond interest.

The interest rates that sovereign governments (such as the UK) borrow at by issuing bonds provides the foundation of modern finance and is invariably the starting point for a discussion with a client about risk and return. For a UK based client who wants to lock into a guaranteed rate of return, essentially 'risk free' over ten years, they can invest in a ten-year UK Gilt issued by HM Treasury currently providing an investment return of 0.8% per annum. After costs, this is not an appealing proposition and is below the rate of inflation, eroding the real purchasing power of that investment over time. To put this into context, investors in 1990 were able to lock into a rate closer to 12% per annum for ten years. Interest rates across the globe have been falling for thirty years and investment and spending decisions have been built upon the premise that interest rates can always be reduced. The global economy is now embedded in a low interest rate environment and investors are assuming interest rates will never rise again.

Much has been made of the fact that the US is currently enjoying its longest economic expansion since the National Bureau of Economic Research (NBER) records began in 1854. The current expansion, which emerged in the dark days of 2009, became the longest in June when it surpassed the previous record of ten years. However, whilst this is a remarkable achievement, which has helped underpin the long bull market in equities, less focus has been on the fact that this has been one of the weakest economic expansions on record. Much of the weakness has been largely attributed to the US consumer, who has broadly concentrated on paying down household debts. The level of overall debt in the US economy has risen as a share of Gross Domestic Product (GDP—size of the economy) from 227% to 247%, largely as a consequence of an increase in government debt to nearly 100%. Research suggests that we are seeing the "scarring" effects of the financial crisis on consumer behaviour, with a reduction in the willingness of an entire generation of households to borrow, as occurred after the Great Depression in the 1930's.

With little or no further room to cut interest rates, the political agenda in the largest economies in the world is gravitating towards the need for greater government spending (known as fiscal policy) on projects such as infrastructure, sustainable energy, hospitals, roads and 5G networks. The International Monetary Fund (IMF) has derived a measure, known as 'fiscal space' to determine if a government has the capacity to raise spending or lower taxes without endangering the markets they have access to or reducing debt sustainability. It's a bit like having money in the bank to boost growth if required for the economy. The analysis suggests that the countries with substantial fiscal space are Korea, Germany, Netherlands and Sweden. The UK has some fiscal space whilst countries like France and Italy have limited ability to increase government spending.

UK equities

The FTSE All-Share Index produced a total return of -1.1% in the period under review. The index is trading some 7% below its high point achieved in May of this year. The FTSE 100 is currently producing a dividend yield of 4.8%, which is competitive relative to other international markets and is six times the current ten-year Gilt yield mentioned earlier in this report. Using a broad range of valuation metrics, the UK market looks reasonably valued relative to other international markets.

Further comment about the UK market continues to be difficult given that Brexit-related developments are making the economic data more volatile. The UK saw the largest drop in economic growth amongst the EU member states in the second calendar quarter of the year following a reasonably strong start to the calendar year. The pound would have purchased 1.30 dollars in April but fell to a low of 1.19 dollars in September due to the fears of a 'no-deal' Brexit, but has since gained some ground back to 1.28 following the appointment of Boris Johnson as the new Prime Minister. Evidence from companies suggests that uncertainty over the UK's future trading relationship with the European Union has become more entrenched, however, the Bank of England continue to forecast a relatively smooth adjustment to the broad range of possible outcomes for the eventual trading relationship. In the three years since the EU referendum, the FTSE All Share Index has produced higher investment returns than an index constructed entirely of UK companies with domestically focussed business models, suggesting that investment decisions in the UK are being delayed in lieu of greater certainty.

The UK consumer has been somewhat cautious since the referendum as monitored by the growth in consumer credit, which has slowed markedly from over 10% per annum to below 6% per annum currently. Two thirds of this decline was attributed to a slowing demand for new car purchases, although the car market went through structural change in 2016 allowing more flexible financing options. The latest statistics suggest that the initial surge in demand may have tailed off.

In 2019, the Construction and Materials sector has performed well as suppliers to the building trade such as Marshalls and Polypipe have seen strong demand. The large pharmaceutical companies such as Astra Zeneca and Dechra Pharmaceuticals have achieved strong investment returns, whilst the Oil and Equipment Services sector continues to struggle despite their strong financial position, low valuations and significant potential upside.

International equities

The S&P 500 Index is used as a broad measure of the total investment return achieved by the largest 500 publicly quoted companies in the U.S. and it rose by 3.0% in the period under review. Following the steep decline of the index at the end of last year (circa -20%), it has recovered well and the US is one of the top performing markets to date and trades at an all-time high. The main driver of the US market has been the performance by Apple Inc (the maker of iPhones), which has increased in value by more than \$400 billion in this year alone. It is now worth \$1.16 trillion and has regained its crown of the most valuable company in the world.

Apple has become the poster child signifying the dominance of the US stock market in recent years, which has benefited from a virtuous cycle of strong demand from passive investors investing in cheap tracker funds but it also illustrates a classic investment conundrum for active investors. Apple's sales and profits are both marginally down for the same time last year and indeed have made little progress since 2015, as iPhone sales have dropped. However, in that time, stock market investors have trebled its valuation and the share price has advanced over 140%. The underlying financial performance of the company does not appear to match its share price performance. Over the last decade, it has used a staggering \$320 billion of its own cash to buy-back some of its own shares but has borrowed significantly to achieve this. This is an accounting technique used by many large US companies in recent years and is a form of financial engineering but it is highly unlikely to be sustainable in the long-run. It seems that low interest rates and the Federal Reserve's QE money is finding its way into the stock market and investors are soaking it up indiscriminately.

In Europe, the MSCI Europe (excl. UK) index, which is used to measure the largest publicly quoted European companies rose by 1.8% in the period under review. Economic growth in the Eurozone remains anaemic and growth for the full year 2019 is likely to be a lowly 1.1%. For 2020, the consensus opinion from economists has downgraded growth to a meagre 0.9%. The domestic economy is still doing well but the weaknesses have been concentrated in industry and exports. International trade disputes and Brexit have had a significant impact according to Jens Weidmann, who is a European Central Bank Council Member. Europe is highly sensitive to global trade and will undoubtedly suffer from a continuing escalation in the US-China trade discussions. European industrial production has been negative since November 2018, but the situation is more desperate in Germany, exacerbated by the diesel emissions scandal. German industrial production is down 6.3% from its peak in November 2017. Given the worsening outlook, it is no surprise that members of the European Central Bank announced an interest rate cut to -0.5% and the re-starting of its Quantitative Easing (QE) programme to the tune of €20 billion a month to help stimulate the economy.

Rather like many of the larger stock markets in the world (except the US), the performance of the emerging markets indicates that they have not managed to breach the high point reached in January 2018. That is almost two years for investors to wait for positive investment returns in this area. It has been noticeable that US exports to China have fallen faster in value than imports from China following the US-China trade talks and the tension between the two countries is a serious headwind for the prospects of the broader emerging markets particularly in 2020. China's economy is still growing at a healthy 6%, whilst India's growth is 7.4%, significantly higher than the developed nations. Seven year forecasts for investing in emerging markets indicate the highest potential investment returns compared to other major equity markets but actual experience has been disappointing in recent years and there are clearly challenges before investment managers will increase their portfolio allocations significantly.

In Japan, the TOPIX 500, a measure of the performance of the largest 500 companies in Japan, produced a total return of -2.0% over the six month period. Japanese firms play a key role in the supply chain of Chinese exports to the US and the economy has been affected by the trade tensions between the two. Japan's economic growth is very slow at 0.4% per annum and the experience of Japanese consumers is that prices have not essentially changed in twenty years. Japan's stock market peaked in December 1989 and has only breached those heights in recent years, some thirty years on.

Fixed interest securities

The ten-year UK Gilt yield is a paltry 0.8%, which is the estimated annualised return an investor should expect to receive over ten years and remains below the rate of inflation. The equivalent U.S. 10-year Treasury bond yield is 1.9%.

Economic uncertainty has remained elevated in the global economy and we look to be entering a period of low economic growth. Heightened political uncertainty in the UK and Europe, ongoing trade tensions between the US and China and political disruptions in Hong Kong and Chile are all negative factors. Economic growth should improve modestly throughout 2020 although, tumbling interest rates (signalled by bond yields) is a strong indicator of a sustained period of lower global growth.

Investors in corporate bonds remain cautious reflecting heightened recession risk, the risks to companies increasing their debt burden and generally poor valuations.

An investor in an investment-graded (the highest credit quality) corporate bond could expect to receive an interest rate approximately 0.8% on average, above the UK Gilt yield, approximately 1.6% in nominal terms at this juncture. In our view, this does not properly compensate investors for the extra risk that they are taking in an asset class that could suffer from liquidity problems (the ability to sell in a timely manner) in the event of a sustained economic downturn. In our view, there are pockets of the global fixed interest market that are offering favourable characteristics such as Mortgage Backed Securities (MBS) in the US, global floating rate notes, UK financial sector preference shares, emerging market bonds and some investment bonds used in the funding of global banks.

Commercial property

Surveys suggest that the UK commercial property market is in the downturn phase of the property cycle although this is largely due to a drop in sentiment contributed by the Brexit impasse. Anecdotal evidence suggests that there is some pent up demand sitting on the side lines waiting for a suitable resolution. That said, the outlook for the commercial real estate sector is consistent with 'a relatively soft landing for capital values overall, even though the fallout from the retail sector is altogether more severe'. In the near term, industrial rents are still rising, office rents are mildly positive, whilst the outlook for rents in the retail sector are deeply in negative territory. Over 60% of chartered surveyors view the overall market as 'fair value', 25% as 'expensive' and 10% as 'cheap'. When surveyors were asked if they have seen any evidence of firms looking to relocate away from the UK in response to the Brexit vote, 30% said 'yes' and 70% said 'no'. One notable comment from a surveyor in Nottingham was the following, 'I see towns becoming ghost towns with vast amounts of big retail space coming onto the market with no demand other than for residential redevelopment.... I often ask the question; who would take this property empty and to let? I get a stony silence in reply.'

Long-term commercial property trends are still evolving alongside new emerging patterns and these include re-purposing empty retail space in high streets and shopping centres to convert into new uses, mostly housing. As more people shop online, high street stores are closing but warehouses and logistics networks are being built. The weaker pound has increased demand for British exports leading to higher demand in industrial space. There is a strong demand for alternative commercial property such as student housing and self-storage. There is a gradual shift to more flexible, shorter-term office leases and companies like the US firm WeWork have found some success in this area.

Alternative asset classes

Crude oil has been trading in a range for most of 2019 and currently sits at \$56.

Paul Farrant, Chartered Financial Analyst

If you would like to find out more or speak to one of our advisers, please contact us: t. 01727 837128 e. info@ifpc.co.uk

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Indices performance statistics are for the period 6th April 2019 to 5th October 2019, total return with income reinvested. Returns are stated in local currency terms unless explicitly stated otherwise.

Source of statistics: PIMFA, Financial Express, Alpha Terminal, Bank of England, Office for National Statistics, Investment Property Databank, CFA Institute (UK), Financial Times.

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